

Sri Lanka's economy and the potential impact from Brexit

Acuity Stockbrokers Research has come out with an assessment on the potential impact from Brexit on the Sri Lankan economy. Here are some highlights of the report

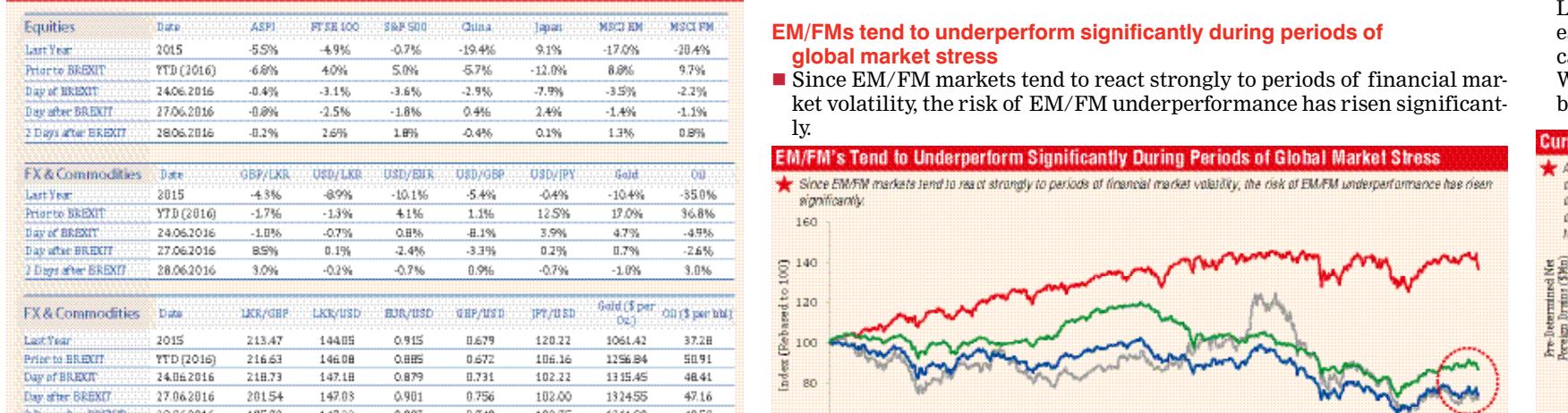
Summary: Brexit rolls global markets

- Britain's decision to exit the European Union sent shock-waves across global markets, as markets had perceived Brexit to be a tail-risk at most. In the immediate aftermath of the decision, the GBP collapsed 8% (against the USD) to its lowest in 30 years, the FTSE 100 crashed 5% intra-day (before closing 3.1% lower), while markets across Asia collapsed as investors fled towards traditional safe-havens such as the USD and gold.
- Concerns over global growth and increased uncertainty pitched investors into 'risk-off' mode immediately, but further developments in the wake of Brexit has created additional insecurity. Following the vote,
 - British Prime Minister David Cameron announced his resignation while Scotland has indicated its dissatisfaction with the vote, highlighting the political fallout from the referendum
 - Moody's downgraded UK's credit ratings outlook to 'negative' due to a 'prolonged period of uncertainty' following the vote. S&P downgraded UK by two notches (from "AAA" to "AA"), while Fitch lowered its rating from "AA+" to "AA."
 - EU leaders have pressed for the UK's swift exit to mitigate further uncertainty

Summary: Sri Lanka impacted via financial and trade channels

- The impact to Sri Lanka via the trade channel could also be significant, as the EU and UK remain major trading partners. The EU is Sri Lanka's largest trading partner (~29% of exports in 2015) and the UK accounts for 35-40% of this proportion. Sri Lanka's primary exports to the region (garments, footwear, tourism and tea) are likely to face some pressure in the short to mid-term while competitive pressures are likely to heighten due to depreciation across most EM/FM currencies.
- Delays in renegotiating trade agreements with EU/UK: Prior to Brexit, Sri Lanka's Prime Minister indicated his optimism that GSP+ with the EU could be regained by year-end. With the recent developments in EU/UK however, there may be delays in negotiations; moreover, new trade deals will have to be negotiated with the UK which will now fall outside the purview of GSP+.
- Heightened competitive pressure: The global 'risk-off' environment implies that EM/FM currencies are likely depreciate across the board, suggesting that the competitive pressures for Sri Lanka's exports are likely to increase in short-medium term.

Summary : Equity, FX & Commodity Performance Before & After BREXIT



Potential impact from Brexit | Emerging market risks increase

EM flows recover and then decline again in May, coinciding with Brexit

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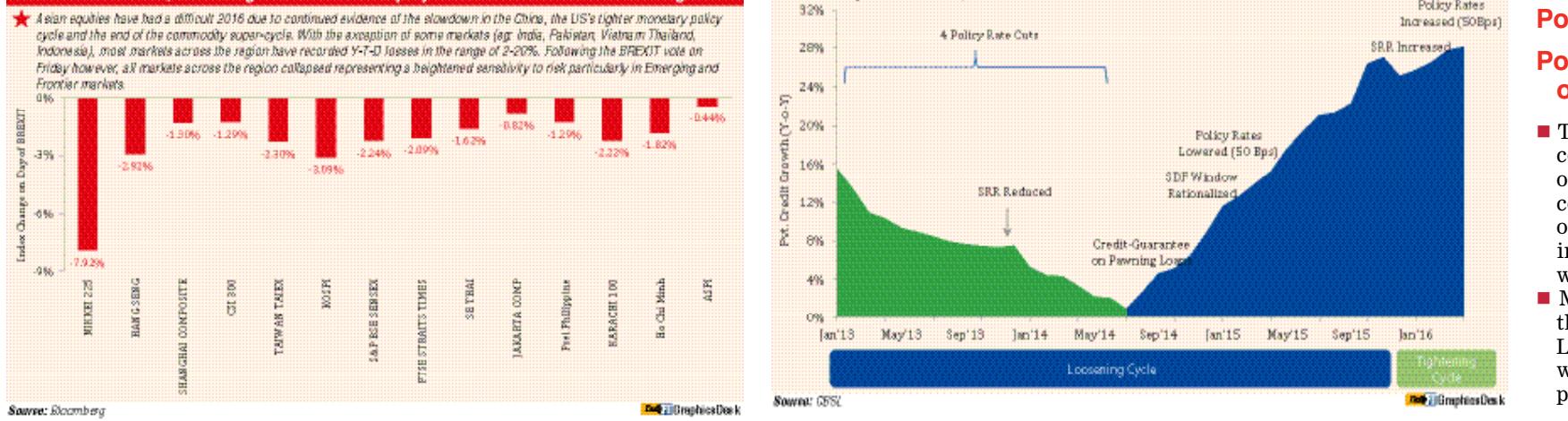
Total Non-Resident Portfolio Flows to Emerging Markets



Asian markets tank, extending YTD losses on equity markets across most of the region

- Asian equities have had a difficult 2016 due to continued evidence of the slowdown in the China, the US's tighter monetary policy cycle and the end of the commodity super-cycle. With the exception of some markets (eg. India, Pakistan, Vietnam, Thailand, Indonesia), most markets across the region have recorded YTD losses in the range of 2-20%. Following the Brexit vote, all markets across the region collapsed reflecting a heightened sensitivity to risk particularly in Emerging and Frontier markets.

Asian markets tank, Extending YTD Losses on Equity Markets Across Most of the Region



In Depth/Issues

Impact of Brexit on global political and economic landscape

BRITAIN'S exit from the EU has been a debate that has been raging for a considerable period of time.

The credit for the exit campaign squarely lies with the Independent Party of UK (UKIP) and its versatile leader Nigel Farage. Nigel has been a vociferous critic of the UK's membership of the EU. Nigel baldly fought for British exit at European Parliament and he was instrumental in creating the public opinion through his eloquent speeches.

Ever since the UK became a member of the EU in 1973, the British political and judicial landscape has had to undergo major reforms as there was a perception that some of the UK standards were in conflict with the EU Charter. The enactment of the Constitution Reform Act of 2005 was one such exercise. UK Human Rights Act of 1998 was introduced to comply with European Convention on Human Rights.

The judgments delivered by the European Court of Human Rights (ECHR) and European Court of Justice (ECJ) have had a direct impact on the British judiciary which had held its independence and reputation for centuries and the British Government had to amend laws to comply with the requirements stipulated by the ECHR and ECJ.

All these legislative measures have had a direct bearing on the sovereignty of Britain which eventually became subordinate to EU Charter which is a stark contradiction of the theory of parliamentary supremacy postulated by the British jurist Albert Dicey.

These changes were indigestible to some of the Euro sceptics.

Opinion was brewing slowly and steadily which culminated on the vote to leave the EU on 23 June. The electoral message was loud and clear. Cameron lost the campaign to stay with the EU.

With huge reserves of oil and gas in Russia and its recent resurgence in economic development and the display of its recent military power the CIS countries would have to re-appraise the unfolding political developments in Europe. However a weakened EU would also create economic woes to all the countries across the globe. If political sanctity does not prevail, it would certainly be the worst catastrophe as Brookings Institution has predicted.

As far as global economic power is concerned, the US still retains the economic and political influence and it would be a folly to disregard US influence on other countries.

After all for US, it is essential to maintain a stronger military presence in Europe and that would require political and economic support to countries hosting US military presence.

There is a strong umbilical cord that binds the US and Europe together over centuries old bonds of cross cultural relations. Since the situation is still unfolding there is a possibility of the birth of yet another political entity of US, Canada and UK on one side cajoling the other to join the new alliance.

Brexit and China

China would certainly gain because EU would no longer be able to mount a strong battle on world stage.

Michael Shuman of Bloomberg asserts that Brexit has provided China with even more economic and political leverage as China challenges the West's most valued institutions and ideals from navigation rights to human rights, the importance of defending those rules and values is rising steadily.

Shuman says that united EU could have presented a serious check to China's growing assertiveness as is demonstrated in South China sea' (emphasis added). When China decided to create a rival to World Bank, US did prevail on European countries to be cautious but Europeans stumbled over themselves to sign up and undermining any hope of extracting concessions from China's leaders.

Impact on Russia and CIS countries

What would be the position of Russia which had until recently been engaged in sabre rattling over NATO expansion overlooking the Russian sphere of influence? Russian military had taken a very aggressive stance over US military engagements in Europe. For Russia there will be a re-appraisal of the concept of market share or the market dominance once again.

There will be a host of other re-appraisal as a result of Brexit.

Impact in Russia and CIS countries

There are simmering trade wars between EU, Americas and Gulf Cooperation Council (GCC) countries especially in the airlines industry. The American and European air carriers are at hammer and tongs with the Gulf carriers such as Emirates Airlines, Qatar Airways and Etihad Airways over government subsidies to oil carriers. Gulf carriers have sought additional frequencies in order to be able to exploit the



for Royal Navy nuclear powered submarines. Nevertheless strong political, economic and cultural ties that Scotland shares with US and UK would dictate a new defence alliance with NATO. Scotland would be a tiny economy under a new dispensation hence the US and British naval presence would certainly augment the domestic economy.

If yet another country follows British precedent then the EU would altogether be an irrelevant factor in Europe.

'Fifth' freedom of the air. With Brexit even airlines are also compelled to redo their maths in light of the changing market share.

EU regulations too will have to restrict the New EU airlines and their frequencies to Europe with the apparent distortion in the market share.

Brexit has caused a whole gamut of changes that require remedies to begin from scratch. As far as airline industry is concerned the biggest source of benefits to UK aviation from EU membership is in the area of traffic rights and the nationality of airlines. Any airline owned and controlled by nationals of EU member states is free to operate anywhere within the EU without restrictions on capacity, frequency or pricing" (Source: Report by www.civiltocivil.com).

The existing air traffic arrangements and the impact of Brexit will certainly have exposed market share and market dominance theory for further scrutiny. There will be renegotiation of trade agreements owing to market distortions.

Brexit and China

EU always had a tough time competing and contending with rising Chinese economic influence in the global market. With a weakened EU China would certainly gain because EU would no longer be able to mount a strong battle on world stage.

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Brexit and the Middle East

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Guest Column

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